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~~SECRET~~ ✓ECONOMIC ASSISTANCE AND U.S. INTERESTS IN CENTRAL AMERICA

U.S. economic aid to the friendly Central American states is an integral element of our response to the current crisis in the region. Humanitarian interests in alleviating misery and meeting the economic and social needs of the people of Central America should not be underemphasized as a motivation for giving aid, but we should acknowledge that our response is driven, in the first instance, by a threat to the security of the United States. In its report, the National Bipartisan Commission on Central America identified the issue precisely: "the intrusion of aggressive outside powers exploiting local grievances to expand their own political influence and military control is a serious threat to the U.S., and to the entire hemisphere." As the Commission recommended, the U.S. response is comprehensive: military aid to meet the externally-assisted insurgency in El Salvador and reinforce the security posture of the "Core Four" states, diplomatic efforts to fashion a workable settlement to conflict in the region, and economic and social progress to improve the lot of the people, encourage democracy and decrease the probability of destabilizing discontent.

If we take as given that the crisis in Central America is regional and cannot be treated solely through assistance to one or two countries, we must determine criteria to answer the essential question: how much economic aid will we give, and to whom? The total amount available for the region is set both by

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our estimate of the need (e.g., balance of payments gaps, capacity for absorption of aid) and the constraints of the U.S. domestic budget process. Allocation among the countries of the region must reflect the level of resources needed to achieve economic growth, or at least prevent economic deterioration, and each nation's willingness to cooperate with us on the overall goals, both political and economic, that will ensure security. The relative levels of aid should not necessarily be interpreted as absolute rankings of the importance of each Central American country to the U.S.

Our experience since the initiation of the Jackson Plan illustrates the criteria for allocation of economic aid.

--El Salvador and Costa Rica received the largest shares of the total because their economies were in the greatest danger of collapse, El Salvador because of the ongoing insurgency and resulting damage to its economy, Costa Rica due to critical foreign exchange shortages caused by the problems of servicing a massive foreign debt.

--We have judged that Costa Rica also deserves continuing support to reward their progress, most significant of all in the region, in adopting and implementing the type of free-market reforms we advocate for sustained economic growth.

--Honduras, no less cooperative on security matters, has

received less economic aid because its needs are less severe and it has demonstrated a lower potential to absorb our assistance effectively or to take necessary economic reform measures.

--Our aid to Guatemala has been constrained by Congressional concerns over the human rights record of the current military government and a reluctance to take adjustment measures.

--Assistance to Panama and Belize have increased markedly under the Jackson Plan, but their position at the periphery of the region has hampered our efforts to obtain more for them from the budget process.

--Nicaragua, of course, receives no U.S. economic aid because of its continuing and growing relationship with the Soviet bloc and its adoption of marxist and statist economic policies. Should these circumstances change, our aid policies and requirements would change accordingly.

WHAT WE GET FOR OUR AID: THE ISSUE OF ECONOMIC CONDITIONALITY

The imposition of certain conditions or guidelines on the use of U.S. economic assistance is mandated by our responsibility to ensure that economic assistance to Central America will be expended in an efficient manner for the purposes of development. We have no desire to create dependencies. On the contrary, our interest in long-term stability in the region - in returning

Central American problems to Central American dimensions, in the words of the Commission - requires us now to prepare the region for the day when U.S. assistance markedly declines or terminates. Conditionality is the principal tool we have to accomplish that end.

U.S. assistance agreements have included three types of conditions: project-related financial and technical requirements; project-related economic policy conditions; and conditions which would change the macroeconomic policies of the recipient country.

Because project aid has a narrow focus and does not provide leverage for comprehensive reform, conditions attached to project aid follow the first type with larger projects also addressing general policy questions in the specific sector when appropriate. Food and other commodity aid funded under Public Law 480 impact on the agricultural sector; significant policy modifications within this sector are appropriate for conditioning PL 480 aid. The potential impact of such sectoral conditions on the balance of payments and/or host government budgets should not be underestimated. Examples of project-related conditionality drawn from recent experience are listed at Tab ____.

Unlike conditions attached to project or commodity aid, conditions on ESF-financed balance of payments support are aimed at macroeconomic policy reforms to bring about economic

stabilization and ensure sustainable growth. Such reforms aim to ensure that external financial inflows will have maximum beneficial impact for long-term economic growth. Such conditionality carries a very high risk of conflict with the recipient government, which may - perhaps correctly - view such measures as a threat to its political position.

The development of conditionality must take into account the local political and security situation. U.S. policymakers need to make careful assessments of, and conscious decisions about, the likely consequences for various U.S. objectives, including political stability, effective bilateral cooperation, security interests, and economic development, of imposing more or less rigorous conditions (or of withholding aid). Rigorous conditions likely to enhance the prospect of sustainable economic growth and improved living standards in the medium to longer term will in many Central American countries involve substantial immediate risk to the government in power and strain our bilateral relationship. Such strains may be sufficiently severe to destroy the principal underlying motive for our aid: elimination of the threat to U.S. security.

Paradoxically, weak economic conditionality, while perhaps lessening the short-term risk of political and foreign policy repercussions, increases the recipient country's dependence on U.S. assistance and the risk of stagnation and instability if our aid levels fall. It also adds to demands on U.S. resources. The

policymaker's task, therefore, is to fashion an assistance program that reflects a proper balance among often competing U.S. objectives. Such a program should include appropriate conditionality that maximizes the chances for achieving the desired economic results without unacceptable damage to other objectives.

Our recent ESF balance of payments assistance programs in Central America, including the programs for Fiscal Year 1984 to Costa Rica, El Salvador, Honduras and Panama, were tied, at least initially, to compliance with comprehensive adjustment programs in the form of existing IMF standby arrangements. Difficulties with this approach arose after mid-1983 as El Salvador's standby expired and was not replaced and Honduras and Costa Rica fell out of compliance. Without standbys in place, the U.S. was forced to consider alternative approaches to conditionality, or freeze disbursements until the Fund relationship was restored. Termination of aid to the Central American democracies because of the lack of Fund programs was judged inconsistent with U.S. interests. The need for alternative approaches to conditionality became even clearer following passage of the Kemp-Kasten amendment to the FY 84 supplemental aid bill, requiring tht U.S. economic assistance not be withheld solely by reason of the policies of multilateral institutions.

Several alternatives have been considered and/or employed in Central America over the past two years. The first retains as

its objective compliance with a comprehensive adjustment program with or without IMF support, designed to remove impediments to growth (e.g., overvalued exchange rates, overly protective tariffs, excessive government deficits, extensive inefficient public sector). Whether the United States is supporting measures beyond those in an IMF program (as we did in Costa Rica in FY 1984), or whether we develop a "shadow program" independent of the Fund, our efforts to enforce comprehensive conditions by granting or holding back ESF places great strains on our bilateral relationship. Moreover, USG efforts in the absence of the Fund have not produced the confidence among private lenders and investors necessary to sustain the same levels of external loan and investment flows.

A second option, development of a less-than-comprehensive "short list" of specified economic reform measures, may lessen the risk of strain and confrontation because the recipient government must meet fewer conditions. However, if we wish to maintain a realistic prospect of progress toward the desired economic goals, the short list will inevitably include the most painful and often most politically difficult measures. The short list option, therefore, is likely to differ little in its initial political consequences from a comprehensive program, although over time it may allow a more distant, less obtrusive U.S. monitoring of recipient-country economic policy and performance.

In situations where comprehensive conditionality proves

Program (TCIP), the Export-Import Bank worldwide credit guarantee program as available for Central America, Housing Investment Guarantees (HIG) and trade credit extended by the Commodity Credit Corporation (CCC). The TCIP, created to alleviate problems with U.S. trade credit flows in the region as a result of Ex-Im's reasonable repayment requirements, is administered by Ex-Im Bank and backed by an ESF-funded reserve. The normal terms of Ex-Im Bank credit guarantees (other than reasonable assurance of repayment) will apply to the TCIP. No other type of conditionality is contemplated. Conditions for HIG's are primarily related to the project and to the housing sector.

CCC credits represent an unusual problem for consideration of conditionality. The program is intended to function as a marketing tool to help develop foreign commercial markets for U.S. agricultural products. As such, and because its terms are at near-commercial rates and subject to creditworthiness considerations, the CCC program (unlike PL-480) should not be regarded as economic assistance. However, many foreign governments, including the Core Four states of Central America, do not make such a clear distinction; they see CCC as another manifestation of U.S. support. This perception is correct in that withdrawal of a customary level of financing contributes to the overall financing problem, necessitating alternative means of funding the commodity imports. Withholding CCC can carry risks similar to those associated with ESF conditionality. These risks should be fully considered in deciding whether to extend CCC

impractical because of recipient government hostility to reform and/or overriding foreign policy or security considerations, a measure of real economic impact may be preserved by converting ESF balance of payments support into projectized aid. The advantage of this approach over weak conditionality is that the assistance can be directed toward productive sectors and supporting infrastructure rather than underwriting inappropriate and potentially damaging short-term policies. It is important to consider that fast-disbursing activities with high local-cost content provide budget support and a degree of balance-of-payments assistance, while high foreign content activities do not finance fiscal or balance-of-payments deficits. Projectizing also may signal to the recipient government that we are serious about requiring meaningful conditions for balance-of-payments support, thus improving chances for obtaining stronger conditionality in the future. Political consequences may be lessened because funds are not frozen, albeit not used as the recipient may prefer, and we can point to our continued support of a friendly nation.

The final option in the spectrum of ESF conditionality is to impose no significant economic policy-conditions. Under this approach ESF balance-of-payments support is used explicitly or implicitly to offset or pay for the host country's costs of cooperation with the U.S. on security and other non-economic objectives. This strategy presents the lowest risk of short-term damage to our bilateral relationship or danger to the government

in power and overall political stability. It postpones to the future any consequences, economic or political, of distortions in the economy created by continued inappropriate policies and of the risk of increased dependence on external assistance. Such distortions tend to worsen over time, increasing the costs, either in terms of painful internal adjustment, or of foreign assistance. This was essentially the approach taken in disbursing FY 1984 ESF to Honduras.

Each of the conditionality strategies outlined implies a number of tactical options. If either a comprehensive adjustment program or shorter list of conditions is selected, the recipient country may be required to meet all conditions before any ESF funds are disbursed, or tranches may be set up either for payment as each condition is progressively met or to ensure continued compliance with the program over time. The "all-or-nothing" tactic and both types of tranching have been used in the past in Central America. The projectizing option may be applied for all or a portion of the total ESF available, or combined with strong or weak conditionality for balance of payment assistance, or combined with both. The proper mix of tactics must be determined by the peculiar circumstances of each case and our judgment of how we may best balance our overall objectives.

Credit Guarantee Programs: The Jackson Plan contains a number of programs which do not fall strictly under the category of economic assistance. These include the Trade Credit Insurance

credits, in what amounts and on what terms.

PRIORITY SECTORS FOR ECONOMIC ASSISTANCE TO CENTRAL AMERICA

(Covered by AID/LAC Draft)

REGIONAL ASPECTS OF THE CENTRAL AMERICA ASSISTANCE EFFORT

The recommendations of the National Bipartisan Commission included strong support for regional solutions to the ills of the Central American region. The Commission warned against attempts to resolve the crisis piecemeal; it asked for "local effort and external support, integrated into a comprehensive approach." The Jackson Plan incorporated the Commission's view of a regional approach in several areas funded by economic assistance, including projects on a regional basis to promote development of education, health and social services, the administration of justice and development of democratic institutions.

Three major recommendations of the Commission to promote regional cooperation have not yet been implemented but are in various stages of development within the USG. They are a fund to revitalize the Central American Common Market (CACM), a contribution to the Central American Bank for Economic Integration (CABEI), and the establishment of a Central American Development Organization (CADO). Consideration of U.S. involvement in CABEI is in the project preparation stage. If a

feasibility study indicates that institutional limitations of the bank can be overcome, we may propose U.S. membership in the organization. The CACM fund idea is in the first stages of study by an AID-financed outside contractor, and we have included in the FY 86 foreign assistance authorization legislation a proposal to establish a CADO that would act primarily as an advisory body. (Our proposal last year for a CADO that would have limited control of a portion of U.S. bilateral assistance to Central America was not approved by Congress.) The ongoing work on these three regional activities may lead to the conclusion that one or more would not represent the best use of our assistance resources or, in the light of changing circumstances in Central America, would not adequately promote the objectives attached to the regional ideal by the Commission. If this proves to be the case, we should not be reluctant to abandon any of these specific projects while maintaining the high priority in the Jackson Plan for activities appropriately pursued on the regional level.

(Add draft on CBI)

The Commission's call for regional solutions to the crisis in Central America also included a challenge to other extraregional donors and the multilateral institutions to join the U.S. and the Central American countries in the effort. Specifically, the Commission estimated that gross flows of resources into Central America required to achieve 1980 living standards in 1990 would need to total at least \$29 billion by

that year. The judgment that such a level was feasible was based on perhaps overly optimistic assumptions about capital flight and the Central American countries' willingness to forego consumption for investment. As the statistics developed in this study point out, the U.S. effort may fall somewhat short of the Jackson Plan's \$8 billion target, but it is more significant and alarming that the actual and projected contributions of the World Bank, Interamerican Development Bank and other bilateral donors are inadequate and disproportionate to their available resources or the gravity of the task. Only Mexico and Venezuela, through the San Jose Oil Facility, have provided resources to the region in proportion to their means. The Europeans, except for a \$19 million pledge to CABEI, have so far contributed only vague promises made at last September's conference in San Jose. The U.S. should increase its efforts to enlist greater support from the multilateral institutions, and from its allies, for the development of the region.

Equally important and perhaps most critical to the prospect of sustainable growth in the region independent of official aid is the mobilization of funds for investment from private external sources, which are projected in this study to be practically non-existent throughout this decade in some Central American countries. The USG can make special efforts to bring encouraging political, security and economic developments to the attention of potential investors, but the success of our overall program to achieve peace, security and sustained growth in the region will

be the primary catalyst of greater investment flows. The inevitable consequence of failure to achieve total resource flows near the amounts recommended by the Commission is to be unable to capitalize on our initial success toward stabilization brought about chiefly by our increased bilateral assistance and close cooperation with international financial institutions.

Drafted:ARA/ECP:STMyles

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